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No. 209

In the Supreme Court of the United States

OCTOBER TERM, 1946

ADAM A. ADAMS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 95a–109a) and dissenting opinions (R. 109a–111a) are reported at 5 T. C. 351. The opinion of the Circuit Court of Appeals (R. 114a–117a) is reported at 155 F. 2d 246.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 16, 1946. (R. 118a.) The petition for a writ of certiorari was filed June 18, 1946. The jurisdiction of this Court is invoked

under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the recapitalization of a corporation, pursuant to which the taxpayer exchanged the common stock owned by him for new common stock and debenture bonds, was undertaken for a corporate business purpose, so that it is to be given effect as a reorganization within the meaning of Section 112 (g) (1) (E) of the Internal Revenue Code.

2. If the exchange was not made pursuant to a statutory reorganization, whether the Tax Court was warranted in its findings that the distribution of the bonds effected a distribution of accumulated earnings or profits under Section 115 (b) of the Internal Revenue Code and that the distribution was taxable as a dividend or its equivalent under Section 115 (a) and (g) of the Code.

STATUTES INVOLVED

The pertinent statutes are set forth in the Appendix, *infra*, pp. 11–13.

STATEMENT

The facts found by the Tax Court (R. 96a–101a), so far as here pertinent, may be summarized as follows:

In the taxable year 1941 the taxpayer was principal stockholder and president of Newark

Theatre Building Corporation, which had an authorized capital of 6,000 shares of common stock of a par value of $100 per share. On January 26 of that year the taxpayer owned 5,903 shares of this stock out of a total of 5,914 which were issued and outstanding. (R. 96a.)

Pursuant to a plan formulated by the directors of the corporation in December 1940, the corporation exchanged its stock for new stock and bonds in the following manner: The authorized capital stock, of which 5,914 shares of $591,400 par value were issued and outstanding, was reduced by 50 percent, to $295,700, divided into 5,914 shares of no par value but having a stated value of $50 per share. The 5,914 shares of $100 par value capital stock were canceled and the corporation issued in exchange therefor an aggregate principal amount of $295,700 in six percent 20-year debenture bonds, plus the 5,914 shares of the new no-par common stock. The exchange was made on the basis of one new share of stock and one $50 bond for each old share. (R. 97a.)

On January 27, 1941, the taxpayer surrendered his 5,903 shares of $100 par value stock and received for each share thereof one share of no par value stock of the stated value of $50, and one $50 debenture bond. (R. 98a.)

On January 26, 1941, the corporation had accumulated earnings and profits available for distribution in a sum not less than $164,514.82. The

new debentures regularly earned and paid the interest due on them, and when received by the taxpayer had a value not less than $164,208.82. (R. 101a.)

The corporate books showed no change in its surplus account following or as a result of the distribution of the bonds. The old par capital stock account was debited in the sum of $591,400, a new no-par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. (R. 98a.)

The Commissioner determined that the taxpayer received a taxable dividend in 1941 in the form of debenture bonds to the extent of the corporation's accumulated earnings in the amount of $164,208.82, and accordingly determined a deficiency in his income tax for that year of $113,021.44. (R. 95a.) The Tax Court found that the recapitalization and distribution of debentures above described had no legitimate business purpose (R. 101a), which would qualify the transaction as a tax free reorganization within the meaning of Internal Revenue Code Section 112, and that such earnings as the corporation had were distributed by means of the debentures to the extent of their value. (R. 106a.) Accordingly, the Tax Court sustained the Commissioner's determination. (R. 108a–109a.)

The Circuit Court of Appeals affirmed. (R. 114–118a.).

ARGUMENT

The courts below both held that the transaction in which the corporation issued stock and debentures in exchange for its outstanding $100 par value stock was not a tax-free reorganization within the meaning of Section 112 (b) (3) and (g) of the Internal Revenue Code. (Appendix, *infra*, p. 11.) This holding has as its premise the view taken by both courts below (R. 102a–103a, 115a–116a), that the plan of recapitalization was not undertaken for a valid business purpose of the corporation. With respect to his argument that the existence of a corporate business purpose is not essential to the recognition for tax purposes of a recapitalization as distinguished from other forms of reorganization, the taxpayer asserts no conflict of decisions. (Pet. 8–9, Br. 19–23.) The taxpayer cannot claim a conflict on this point with *Bass* v. *Commissioner*, 129 F. 2d 300 (C. C. A. 1), because in the *Bass* case the reorganization was motivated by corporate business reasons not present here; for example, to provide the corporation with marketable treasury shares which might later be used for corporate business purposes (129 F. 2d at 303–304).[1]

[1] The four reasons advanced for the recapitalization were rejected by the Tax Court, either as not credible or as reasons personal to the stockholders rather than for the benefit of the corporation. (R. 102a–103a.) Thus, the motivations asserted were: (1) That the new bonds could be used as collateral to facilitate a refinancing of the corporation's mort-

Having reached the conclusion that the transaction here was not a tax-free recapitalization, the course was open to the courts below, if not mandatory upon them, to hold that the distribution of the debentures was a distribution, to the extent of their market value, of such earnings and profits as were in the corporate treasury, *i. e.*, a dividend or a distribution in the nature thereof,[2] and is taxable as a dividend. This treatment was called for because the issuance of the new debentures was a distribution of property in a form in which dividends may be declared and paid, and

gage indebtedness. But the bonds were never so used; moreover, the bonds were inferior to the mortgage lien itself and could not be as attractive to a secured creditor as common stock which would give him some voice in the business. (2) That the taxpayer wanted to give his sons an interest in the business without surrendering stock control. This reason was personal to the taxpayer. (3) That the corporation could save corporate franchise taxes by reducing its capital, and (4) could save income taxes by deducting the interest on the bonds. But the franchise and income tax savings were greatly exceeded by the interest payable to the bondholders, and no advantage resulted to the corporation as distinguished from its shareholders to whom the bonds were issued. The taxpayer does not challenge in this Court the finding, in which the court below concurred (R. 115a–116a), that the recapitalization here had no corporate business purpose if a corporate business purpose is required.

[2] The same result is reached here, whether the transaction is treated as a distribution of debentures within the definition of a dividend contained in Section 115 (a) (Appendix, *infra*, pp. 11–12), or as a redemption of stock at such time and in such manner as to make the distribution and cancellation or redemption the essential equivalent of a taxable dividend, under Section 115 (g) (Appendix, *infra*, p. 12).

the corporation had accumulated earnings and profits in at least the amount of the value of the debentures. Given a distribution by the corporation it follows that the distribution was a dividend, for "The term 'dividend' * * * means any distribution * * *, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, * * *" (Internal Revenue Code, Sec. 115 (a), Appendix, *infra*, pp. 11–12); and, for the purposes of the income tax chapter of the Code, "every distribution is made out of earnings or profits to the extent thereof * * *" (*id.*, Sec. 115 (b), Appendix, *infra*, p. 12). This conclusion could not be affected by the fact that no debit was entered on the books of the corporation against its surplus account, for Section 115 (b) conclusively attributes any distribution to earnings and profits if they exist. *Beretta* v. *Commissioner*, 141 F. 2d 452 (C. C. A. 5), certiorari denied, 323 U. S. 720. It is only on this point that the taxpayer asserts a conflict with *Bass* v. *Commissioner*, *supra*. (Pet. 8, 14–18.)

There is no conflict with the *Bass* case. There the court held (129 F. 2d at 306) that there was an exchange of securities pursuant to a recapitalization having a valid business purpose and upon which, therefore, no gain or loss was to be recognized under Section 112 (b) (3) (Appendix, *infra*, p. [redacted]). The Commissioner had contended,

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without regard to the question whether there was a business purpose, that there was no exchange, but rather, a distribution of new preferred stock as a stock dividend, with a mere and colorless change in par value of the 600,000 shares of stock which were outstanding both before and after the transaction. The court having rejected the Commissioner's contention and having held that there was an exchange in a reorganization pursuant to Section 112 (b) (3), that section prescribed that no gain or loss was to be recognized. Then Section 115 (h) (1), (Appendix, *infra;* pp. 12–13) came into play with its provision that a distribution shall not be considered a distribution of earnings or profits if no gain to the distributee from the receipt of the new securities was recognized by law. In that view, as the court there held, Section 115 (b), which forms the basis for the holdings here, was irrelevant in that case, although the court fully recognized that if Section 115 (b) had been relevant it would have called for the same result reached here. "The latter subsection attributes a source to distributions when distributions are made * * *." (129 F. 2d at 308.) The *Bass* case does not hold, as the taxpayer here contends, that Section 115 (b) may be ignored in favor of corporate bookkeeping concepts where the requirements for a tax-free exchange under Section 112 are missing and a distribution in fact is found.

The taxpayer further maintains (Pet. 9, Br. 24–29) that though the transaction here could not qualify as an exchange in a reorganization tax-free under Section 112 (b) (3), the transaction in which it gave up common stock for common stock and debentures was nevertheless an exchange, and that its tax consequences are therefore to be governed either by Section 112 (b) (2), 112 (c) (1) and (e), or by Section 112 (a)[3]— in any event, by Section 112 to the exclusion of any treatment which might be given under Section 115. Yet it seems clear that a distribution of property such as to constitute a distribution of earnings or profits within the meaning of Section 115 (a) can occur even though something is given up by the distributee simultaneously with the distribution, and a distribution and cancellation or

[3] Section 112 (a) provides that upon a sale or exchange of property the entire gain or loss shall be recognized, except as provided in Section 112. Where Section 112 (a) is applicable and no exception is controlling the gain or loss upon an exchange of stock for stock and bonds would be taken into account and taxed at capital gains rates. The taxpayer claims to be within the exception to Section 112 (a) contained in Section 112 (b) (2), 112 (c) (1) and 112 (e), that where common stock is exchanged solely for common stock in the same corporation, except for other property issued in addition, gain shall be taken into account to the extent of the fair market value of the other property, and loss shall not be recognized. The Tax Court made no findings as to whether the taxpayer sustained a gain or loss upon the transaction. In its view that the issuance of the debentures was a distribution of earnings and profits, such an inquiry was irrelevant.

redemption within the meaning of Section 115 (g) can occur and can be the equivalent of a taxable dividend even though the distribution is in property rather than in money. The taxpayer cites no authority that a distribution otherwise taxable as a dividend cannot be so treated when it is made as a part of an exchange, or that the exchange provisions of Section 112 exclude the operation of Section 115.

The majority of the court below regarded the dispute as one in which the conclusions of the Tax Court have finality under *Dobson* v. *Commissioner,* 320 U. S. 489, both with respect to the lack of a business purpose in the reorganization and with respect to the treatment to be given to the debentures (R. 117a), although the court fully stated its agreement with the criteria used by the Tax Court (R. 116a–117a). There is no conflict of decisions.

CONCLUSION

The petition should be denied.

Respectfully submitted.

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JULY 1946.

APPENDIX

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * * *

(g) [as amended by Section 213 (b), Revenue Act of 1939, c. 247, 53 Stat. 862.] *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means * * *, or (E) a recapitalization, * * *. (26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings

or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on

behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

(26 U. S. C. 1940 ed., Sec. 115.)

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